

Message Text

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SUBJECT: PROGRESS ON VAT BASE HARMONIZATION AND IMPLICATIONS
OF "OWN RESOURCES"

REF: (A) EC BRUSSELS 10454, (B) EC BRUSSELS A-527, 12/29/75

1. SUMMARY: COMMUNITY SOURCES EXPRESS OPTIMISM ON A SUCCESSFUL
RESOLUTION OF REMAINING ISSUES REGARDING VAT BASE HARMONIZATION
AT THE FISCAL COUNCIL MEETING DECEMBER 16. HOWEVER, THERE IS
CONSIDERABLE DOUBT WHETHER WORK ON FINALIZING THE SIXTH
DIRECTIVE ON VAT HARMONIZATION WILL PROGRESS RAPIDLY ENOUGH
TO LEAVE TIME FOR THE IMPLEMENTATION OF THE DIRECTIVE BY THE
TARGET DATE OF JANUARY 1, 1978. THE PRINCIPAL IMPORTANCE OF
VAT BASE HARMONIZATION IS THAT IT IS A PREREQUISITE FOR THE
IMPLEMENTATION OF THE DECISION TO INSTALL A FULL "OWN RESOURCES"
BUDGETARY SYSTEM IN THE COMMUNITY. THIS WILL HAVE MINOR
EFFECTS IN THE SHORT RUN, BUT PERHAPS MORE PROFOUND EFFECTS
IN THE LONGER TERM IN INCREASING COMMUNITY FISCAL INDEPENDENCE.
END SUMMARY.

2. SINCE THE OCTOBER 21 FISCAL COUNCIL (REF A) THE
EC COUNCIL VAT WORKING GROUP HAS BEEN MEETING INTEN-
SIVELY ON THE EC COMMISSION'S PROPOSED SIXTH DIRECTIVE
ON THE HARMONIZATION OF THE VALUE-ADDED TAX (VAT) ASSESS-
MENT BASE AMONG MEMBER STATES. LAST WEEK, THE WORKING
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GROUP HELD ITS FINAL MEETING PRIOR TO THE FISCAL

COUNCIL MEETING SCHEDULED DECEMBER 16. COREPER WILL CONTINUE TO DISCUSS SOME ISSUES THIS WEEK.

3. GIVEN THE PROGRESS MADE AT THE OCTOBER 21 FISCAL COUNCIL AND SINCE THEN IN THE WORKING GROUP, PERMDEL, COUNCIL, AND COMMISSION SOURCES ARE OPTIMISTIC THAT THE DECEMBER 16 FISCAL COUNCIL WILL BE ABLE TO RESOLVE ALL REMAINING SUBSTANTIVE ISSUES, PAVING THE WAY FOR FINAL ADOPTION OF A SIXTH DIRECTIVE. THIS WOULD BE A STEP TOWARDS FISCAL HARMONIZATION AMONG MEMBER STATES, AND WOULD PROVIDE A SUFFICIENTLY UNIFORM BASIS OF VAT ASSESSMENT TO ALLOW THE EC BUDGET TO MOVE TO A FULLY "OWN RESOURCES" BASIS. THE ADDITIONAL REVENUE REQUIRED TO PUT THE EC BUDGET ON THIS BASIS IS TO BE OBTAINED BY TAPPING MEMBER STATE VAT REVENUES AT A RATE NOT EXCEEDING ONE PERCENT ON A UNIFORM ASSESSMENT BASE. THIS WOULD REPLACE THE FINANCIAL CONTRIBUTIONS OF MEMBER STATES WHICH ARE NOW COMBINED WITH PRESENT OWN RESOURCES (CUSTOMS DUTIES AND AGRICULTURAL LEVIES) TO MAKE UP BUDGETARY REVENUES. (FOR ADDITIONAL BACKGROUND SEE REF B).

4. THE DEADLINE FOR FINAL ADOPTION OF THE SIXTH DIRECTIVE HAD BEEN SET FOR JANUARY 1, 1977, SINCE IT WAS CONSIDERED THAT A FULL TWELVE-MONTH PERIOD WOULD BE REQUIRED FOR MEMBER STATE LEGISLATION AND ADMINISTRATIVE CHANGES AS NEEDED TO IMPLEMENT THE DIRECTIVE BY JANUARY 1, 1978. THIS IS THE TARGET DATE FOR THE COMMUNITY BUDGET TO BE PUT ON AN OWN RESOURCES BASIS.

5. OUR SOURCES DIFFER ON WHETHER THE FINAL VERSION OF THE DIRECTIVE WILL IN FACT BE READY FOR ADOPTION SOON ENOUGH TO PERMIT THE 1978 TARGET DATE TO BE MET. IT SEEMS FAIRLY CLEAR THAT THE JANUARY 1, 1977 DEADLINE WILL NOT BE MET, EVEN IF THE DECEMBER 16 FISCAL COUNCIL IS SUCCESSFUL. MUCH WILL REMAIN TO BE DONE IN CLEARING AWAY TECHNICAL DETAIL AND IN RE-DRAFTING THE DIRECTIVE TO ACCORD WITH THE COUNCIL'S DECISION. SOME COUNCIL AND PERMDEL SOURCES SAY IT WILL BE IMPOSSIBLE TO FINISH THIS WORK BEFORE EASTER AT THE EARLIEST. THESE SOURCES SUGGEST THAT THE 1978 TARGET DATE WILL EVENTUALLY NEED TO BE LIMITED OFFICIAL USE

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POSTPONED, EVEN THOUGH IT MAY BE MAINTAINED FOR THE TIME BEING TO APPLY MAXIMUM PRESSURE. (ITALY APPEARS TO BE A PARTICULAR WORRY HERE AS REGARDS RAPID ACTION TO IMPLEMENT THE DIRECTIVE). OTHER SOURCES SUGGEST THAT THE FINAL DIRECTIVE MAY BE READY FOR ADOPTION AROUND FEBRUARY 1, AND THAT THIS MIGHT BE SOON ENOUGH TO PERMIT HOLDING TO THE PLAN FOR PLACING THE 1978 BUDGET FULLY ON OWN RESOURCES. IT WOULD BE POSSIBLE, THESE SOURCES POINT OUT, FOR

CONSULTATIONS WITH LEGISLATIVE BODIES TO BEGIN EVEN BEFORE FINAL LANGUAGE IS ADOPTED. ONE COMMISSION SOURCE RESOLUTELY REFUSES TO ADMIT TO THE POSSIBILITY THAT POSTPONEMENT OF THE 1978 TARGET DATE MAY BE NECESSARY.

6. THE SUCCESS OF THE FISCAL COUNCIL ON DECEMBER 16 CANNOT BE TAKEN COMPLETELY FOR GRANTED. THERE WILL BE A LONG LIST OF DECISIONS TO BE MADE, SOME INVOLVING SENSITIVE QUESTION. INFORMED SOURCES PREDICT THAT THE COUNCIL PRESIDENCY WILL PRESENT A PACKAGE DEAL, DESIGNED TO BALANCE OFF CONCESSIONS AMONG MEMBER STATES, BUT THAT THIS IS NOT LIKELY TO BE ACCEPTED UNTIL AFTER A GREAT DEAL OF PRESSURE HAS BUILT UP LATE IN THE EVENING.

7. THE GOOD PROSPECTS FOR AGREEMENT OWE A GOOD DEAL TO THE COMPROMISE DEVICE PROPOSED BY THE DUTCH PRESIDENCY AT THE OCTOBER 21 MEETING (REF A). THIS PROPOSAL OFFERED A WAY TO ATTACK THE STICKY PROBLEM OF WHICH ACTIVITIES WOULD BE EXEMPTED FROM THE HARMONIZED VAT BASE. NATIONAL PRACTICES DIFFER IN MANY RESPECTS, AND MEMBER STATES HAVE BEEN RELUCTANT TO AGREE TO CHANGES BECAUSE OF ADMINISTRATIVE COSTS AND THE VESTED INTERESTS INVOLVED. THE DUTCH PROPOSAL DIVIDED CURRENT EXISTING EXEMPTIONS INTO SEVERAL CATEGORIES. LIST I CONTAINED ACTIVITIES ON WHICH EXEMPTION PRACTICES WOULD BE HARMONIZED IMMEDIATELY -- SOME ACTIVITIES TO BE EXEMPTED BY ALL MEMBER STATES, OTHERS TO BE TAXED BY ALL MEMBER STATES (I.E., EXISTING EXEMPTIONS ENDED). LIST II CONTAINED ACTIVITIES ON WHICH THE ULTIMATE AGREED AIM WOULD BE EXEMPTION, BUT MEMBER STATES WOULD BE PERMITTED TO MAINTAIN CURRENT PRACTICES DURING A TRANSITION PERIOD. LIST III CONTAINED ITEMS ON WHICH THE ULTIMATE AIM WOULD BE TAXATION, BUT AGAIN EXISTING PRACTICES COULD BE MAINTAINED DURING A TRANSITION LIMITED OFFICIAL USE

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PERIOD. LIST IV WOULD CONTAIN ITEMS ON WHICH NO AGREEMENT COULD BE REACHED, IF SUCH COULD NOT BE AVOIDED.

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8. LIST I AND II WOULD INVOLVE NO DIFFICULTIES FOR OWN RESOURCES DURING THE TRANSITION PERIOD. (MEMBER STATES CONTINUING TO COLLECT TAXES DURING THE TRANSITION PERIOD ON ACTIVITIES ON LIST II WOULD SIMPLY NOT HAVE TO TURN OVER ANY PORTION TO THE COMMUNITY). THOSE COUNTRIES NOT COLLECTING VAT DURING THE TRANSITION PERIOD ON THE ACTIVITIES ON LIST III WOULD NEED TO ESTIMATE HYPOTHETICAL AMOUNTS WHICH THEY WOULD THEN TURN OVER TO THE COMMUNITY AS COMPENSATION. INsofar AS POSSIBLE, THESE ESTIMATES WOULD HAVE TO BE BASED ON ACTUAL TAX RETURNS. IN CASES WHERE THIS WAS IMPOSSIBLE, COMPENSATION WOULD BE MADE ON THE BASIS OF WHATEVER STATISTICAL EVIDENCE IS AVAILABLE. SHOULD ITEMS HAVE TO BE PLACED ON LIST IV, NO COMPENSATION WOULD BE PAID UNLESS THE AMOUNTS INVOLVED WOULD BE OF SIGNIFICANCE RELATIVE TO THE BUDGET OR THE MEMBER STATES'S CONTRIBUTION. IN THIS CASE, THE COUNCIL WOULD NEED TO BE PAID, OR WHETHER THE ACTIVITY WOULD BE EXCLUDED FROM THE OWN RESOURCES BASE. THUS THE SYSTEM WOULD APPROXIMATE AS CLOSELY AS POSSIBLE AMOUNTS THAT WOULD BE DUE IF THE BASE WERE FULLY HARMONIZED.

9. THE FINAL PLACEMENT OF SEVERAL OF THE MORE DIFFICULT ITEMS ON THE LIST MUST AWAIT FINAL COUNCIL DECISION. THESE INCLUDE THE TAXATION OF VARIOUS FINANCIAL SERVICES, TRANSACTION IN GOLD, AND PROFESSIONAL SERVICES OTHER THAN MEDICAL (I.E., LEGAL FEES). IN ADDITION, A SEPARATE LIMITED OFFICIAL USE

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ITEM NOT ON THE LIST, INTERNATIONAL RAIL AND ROAD PASSENGER TRANSPORTATION HAS BEEN EXTREMELY DIFFICULT TO DEAL WITH. (GIVEN THAT INTERNATIONAL AIR AND SEA TRANSPORTATION IS NOT TAXED, BUT INTERNAL PASSENGER TRANSPORTATION IS TAXED, EITHER TAXING OR NOT TAXING INTERNATIONAL RAIL AND ROAD PASSENGER TRANSPORTATION INVOLVES DIFFICULT PROBLEMS).

10. THE ISSUE OF ZERO (OR VERY LOW) RATES HAS BEEN DEFUSED BY AN AGREEMENT TO ALLOW MEMBER STATES TO KEEP, DURING THE TRANSITIONAL PERIOD, THOSE ZERO OR REDUCED RATES IN EFFECT ON DECEMBER 31, 1975. THUS THE IRISH WILL NO LONGER BE THREATENED WITH COURT ACTION OVER ZERO RATES INTRODUCED SUBSEQUENT TO THE SECOND DIRECTIVE, BUT PRIOR TO 1976. COMPENSATION WILL HAVE TO BE PAID BY COUNTRIES APPLYING ZERO RATES, BASED ON ACTUAL RETURNS. (SEE REFS FOR BACKGROUND).

11. THE LENGTH OF THE TRANSITIONAL PERIOD WILL BE A CENTRAL ISSUE TO BE DECIDED NEXT WEEK. UNDER THE DUTCH PROPOSAL, THE TRANSITIONAL PERIOD WOULD BE AN INDEFINITE PERIOD, LASTING UNTIL A DECISION HAS BEEN TAKEN TO ELIMINATE ALL FISCAL FRONTIERS. HOWEVER, DEROGATIONS (E.G., ZERO RATES, LISTS II AND III) WOULD BE REVIEWED EVERY FOUR YEARS, AND COUNTRIES WOULD HAVE TO PROVIDE JUSTIFICATION FOR THEIR CONTINUED EXISTENCE AT THOSE TIMES. SOME MEMBER STATES (E.G., BELGIUM), ARE LIKELY TO PRESS FOR A MORE DEFINITE AND RELATIVELY BRIEF TRANSITION PERIOD AT THE DECEMBER 16 MEETING. IT IS POSSIBLE THAT DIFFERING TRANSITIONAL PERIODS WILL BE APPLIED TO DIFFERENT PROBLEMS.

12. TWO OF THE OTHER MORE DIFFICULT ISSUES TO BE DECIDED AT THE DECEMBER 16 COUNCIL MEETING ARE:

(A) THE TAXATION OF AGRICULTURAL ENTERPRISES, CURRENTLY TAXED UNDER A FLAT RATE SYSTEM IN SOME MEMBER STATES. (THE FLAT RATE SYSTEM ALLOWS FARMERS TO DEDUCT A FLAT PERCENTAGE OF INPUT COSTS RATHER THAN ACTUAL VAT PAID ON THOSE INPUTS IN ORDER TO REDUCE RECORD KEEPING REQUIREMENTS). THE COMMISSION WILL CONTINUE TO PRESS FOR ARRANGEMENTS THAT WILL REDUCE THE LIMITED OFFICIAL USE

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APPLICATION OF THE FLAT RATE SYSTEM AND PROVIDE INCENTIVES TO MOVE TO A STANDARD VAT SYSTEM. IN THE MEANTIME A CONSISTENT MEANS OF ASSESSING THEIR OWN RESOURCES CONTRIBUTION WILL NEED TO BE AGREED TO.

(B) THE THRESHOLD LEVEL BELOW WHICH SMALL BUSINESSES DO NOT HAVE TO PAY VAT WILL PROBABLY NOT BE HARMONIZED IMMEDIATELY. INSTEAD, A TENTATIVE AGREEMENT HAS BEEN REACHED WHICH WOULD SET A 4,000 U.A. ANNUAL TURNOVER THRESHHOLD AS AN ULTIMATE AIM. COUNTRIES WOULD BE ABLE TO KEEP PRESENT PRACTICES DURING THE TRANSITIONAL PERIOD. FOR PURPOSES OF THE OWN RESOURCES CONTRIBUTION, HOWEVER, THE THRESHHOLD WILL BE SET HIGH -- PROBABLY AT 10,000 U.A. -- UNTIL ACTUAL THRESHHOLDS ARE

COMPLETELY HARMONIZED. THE QUESTION OF THE ADJUSTMENT OF THE THRESHHOLD FOR INFLATION NEEDS TO BE SETTLED.

13. COMMENT: THE PRECISE FORM ULTIMATELY TAKEN BY THE EC HARMONIZED VAT ASSESSMENT BASE MAY HAVE CONSIDERABLE IMPACT ON THE INDIVIDUAL SECTORS INVOLVED, BUT IS OF ONLY MINOR SIGNIFICANCE FOR U.S. INTERESTS. THUS, THE SKETCH OF SOME DETAILED PROBLEMS ABOVE WAS INCLUDED PRIMARILY TO GIVE AN IDEA OF THE TYPES OF OBSTACLES INVOLVED. THE STRUGGLE TO ACHIEVE VAT BASE HARMONIZATION, HOWEVER, DOES HAVE SOME BROADER SIGNIFICANCE AS IT AFFECTS, AND IS AN INDICATOR OF, THE COHESION AND STRENGTH OF THE COMMUNITY.

14. AS NOTED ABOVE, HARMONIZATION OF THE VAT BASE IS A SMALL STEP TOWARDS FISCAL HARMONIZATION -- THE REMOVAL OF FISCAL FRONTIERS WITHIN THE COMMUNITY -- AND THUS TOWARDS THAT DISTANT AND ELUSIVE GOAL OF ECONOMIC AND MONETARY UNION. HOWEVER, THE COMPROMISES ON HARMONIZING THE VAT BASE WILL, FOR THE TIME BEING AT LEAST, LEAVE SOME TAX DIFFERENCES AS OBSTACLES TO THE FREE MOVEMENT OF GOODS AND LABOR, AND CAUSE A SHORTFALL FROM THE GOAL OF A FULLY INTEGRATED MARKET.

15. OF MORE SIGNIFICANCE, PERHAPS, SUCH HARMONIZATION (OR QUASI-HARMONIZATION DURING THE TRANSITION PERIOD) WILL ALLOW THE IMPLEMENTATION OF THE FULL "OWN RESOURCES" BUDGETARY SYSTEM, A STEP TOWARDS MORE FISCAL INDEPENDENCE LIMITED OFFICIAL USE

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FOR THE COMMUNITY. IN THE SHORT TERM THIS IS UNLIKELY TO MAKE MUCH PRACTICAL DIFFERENCE TO THE BUDGET, SINCE THE EC'S VAT RATE WILL BE ADJUSTED (UP TO A MAXIMUM OF 1 PERCENT) TO COVER RESIDUAL NEEDS (I.E., EXPENDITURES NOT COVERED BY OTHER OWN RESOURCES) JUST AS THE NATIONAL CONTRIBUTIONS KEYED TO GNP ARE ADJUSTED UNDER PRESENT ARRANGEMENTS. IN THE LONG RUN, HOWEVER, FULL IMPLEMENTATION OF THE OWN RESOURCES PRINCIPLE, COMBINED WITH INCREASED PARLIAMENTARY BUDGETARY POWERS, COULD GIVE THE COMMUNITY A MEASURE OF REAL BUDGETARY AUTONOMY.

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16. UNDER PRESENT CONDITIONS, WITH THE COUNCIL STILL HOLDING ON TO THE UPPER HAND IN BUDGETARY MATTERS, THE SWITCH TO A FULL OWN RESOURCES SYSTEM PROVIDES LITTLE REAL FISCAL INDEPENDENCE, BECAUSE REVENUES WILL STILL ADJUST TO EXPENDITURES, AND DECISIONS ON EXPENDITURES ARE STILL LARGELY MADE BY THE MEMBER STATES. HOWEVER, THE "OWN RESOURCES" SYSTEM WILL PROVIDE A MARGIN OF FISCAL MANEUVER (WITHIN THE 1 PERCENT VAT REVENUE CEILING) TO THE PARLIAMENT (A MORE "EUROPEAN" BODY AFTER DIRECT ELECTIONS), WHICH IS GRADUALLY GAINING MORE SAY IN THE BUDGETARY PROCESS. THE FREEDOM OF MANEUVER, HOWEVER, WILL DECREASE AS MORE AND MORE OF THE 1 PERCENT MARGIN IS ABSORBED. CURRENT ESTIMATES, FOR EXAMPLE, SUGGEST THAT THE BUDGET WILL REQUIRE THE COMMUNITY TO UTILIZE A VAT RATE OF ABOUT 0.7 PERCENT IN 1979, WITHOUT TAKING INTO ACCOUNT THE POSSIBLE "BUDGETIZATION" OF COMMUNITY AID ACTIVITIES (THE EDF). THUS, A FUTURE STRUGGLE OVER PRESSURES TO RAISE THE 1 PERCENT CEILING ON VAT OWN RESOURCES CAN ALREADY BE FORESEEN.

17. ANOTHER CONSEQUENCE OF A SUCCESSFUL MOVE TO OWN RESOURCES IN 1978 WOULD BE TO TAKE THE STING OUT OF THE IMPACT ON NATIONAL BUDGETARY CONTRIBUTIONS OF A REFORM IN THE BUDGETARY UNIT OF ACCOUNT. THE USE OF THE PRESENT UNIT OF ACCOUNT, BASED ON FIXED, OUTDATED EXCHANGE RATES, TENDS, UNDER THE PRESENT SYSTEM, LIMITED OFFICIAL USE

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COUNTRIES WITH WEAKENING EXCHANGE RATES. THE SHIFT TO A MORE RATIONAL UNIT OF ACCOUNT, HOWEVER, WOULD HAVE NO IMPACT ON BUDGETARY BURDEN SHARING UNDER A FULL OWN RESOURCES SYSTEM. (IT WOULD, HOWEVER, STILL HAVE AN IMPACT ON

RESOURCE TRANSFERS THROUGH THE EXPENDITURE SIDE).

18. THIS IS NOT TO SAY THAT THE SHIFT TO OWN RESOURCES PROTECTS THE POSITION OF THE WEAKER COUNTRIES. THE REVERSE IS TRUE, SINCE THE INCIDENCE OF THE VAT TENDS TO BE REGRESSIVE AS BETWEEN RICHER AND POORER COUNTRIES -- I.E., THE VAT BASE IS MUCH LARGER IN PROPORTION TO GNP IN THE U.K. THAN IN GERMANY. THE IMPACT OF THIS ON THE NEWER MEMBERS OF THE COMMUNITY WILL BE CUSHIONED UNTIL 1980 BY THE TRANSITIONAL ARRANGEMENTS. AFTER THAT DATE, THE REGRESSIVE IMPACT WILL CONTINUE TO BE MITIGATED BY THE OPERATION OF THE FINANCIAL MECHANISM AGREED TO IN THE BRITISH RENEGOTIATIONS.

19. FINALLY, IT MAY BE REASONABLE TO VIEW THE PROLONGED NEGOTIATIONS OVER VAT BASE HARMONIZATION AS AN EXAMPLE OF COMMUNITY WEAKNESS. THE SPECTACLE OF LENGTHY QUARRELS OVER SUCH SUBJECTS AS WHETHER THE VAT SHOULD APPLY TO GREYHOUNDS AND UNDERTAKERS HAS NOT BEEN HELPFUL TO THE COMMUNITY'S IMAGE. AT THE SAME TIME, IT SHOULD BE RECOGNIZED THAT EACH MEMBER STATE IS BEING ASKED TO GIVE UP, SOONER OR LATER, NATIONAL PRACTICES TAILORED TO INDIVIDUAL ECONOMIC CIRCUMSTANCES IN EXCHANGE FOR BENEFITS TO FLOW FROM A STRENGTHENED COMMUNITY. THAT AN AGREEMENT TO DO THIS NOW APPEARS IMMINENT SUGGESTS THAT COMMITMENT TO A STRENGTHENED COMMUNITY IS NOT COMPLETELY LACKING. END COMMENT.HINTON

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